

NATIONAL FORECAST DESCRIPTION

The Forecast Period is the First Quarter of 2004 through the Fourth Quarter of 2007

It appears the national economy has successfully transitioned from policy-supported growth to self-sustaining growth. Stimulative monetary and fiscal policies kept the recovery moving ahead despite the lackluster job market. Well-timed tax cuts put money in consumers' hands and kept spending from retreating. As a result, the consumer sector kept the economy afloat. Record low interest rates also helped. The Federal Reserve lowered its federal funds rate to 1.0% in order to keep the economy from sinking. Other interest rates followed suit. Mortgage interest rates also dropped to a generational low, and the housing market boomed as a result. Despite this growth, inflation remained tame. One of the reasons price increases remained subdued was because of the weak labor market. During the "jobless recovery" there was little inflationary pressure from wages.

One of the concerns about the "jobless recovery" was policy makers were quickly running out of options. The return of federal budget deficits suggested further tax relief would be improbable. The Federal Reserve, whose job it is to walk the razor's edge between growth and inflation, found itself running out of razor. With the federal funds rate already at 1.0% and fears of deflation rising, it was not likely it could drop rates much further. In fact, in a lesson learned from the Japanese central bank, even 0% short-term interest rates cannot guarantee growth. The hope was that U.S. job creation would kick into higher gear. The robust job growth would increase income. The stronger income growth would be an important component in the engine propelling future growth.

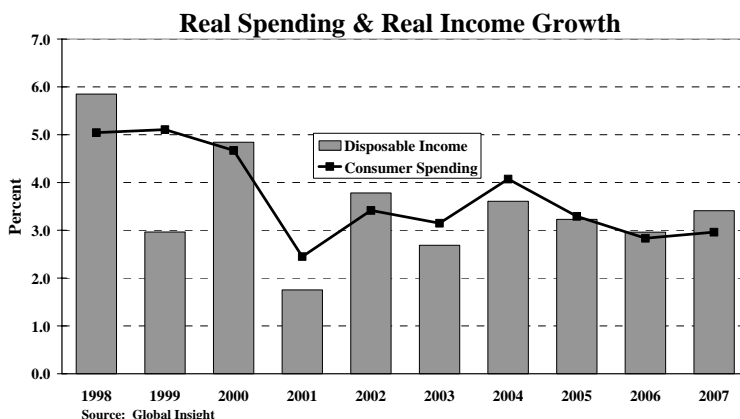
Unfortunately, the trip to a self-sustaining recovery had its share of false starts. As was mentioned above, a key ingredient to being self-sustaining is jobs. Last winter it appeared strong employment growth had finally returned. This recovery proved to be short-lived; the economy failed to post significant jobs gains after the initial increase. Fortunately, this seems to have been fixed. In the spring of 2004, the U.S. economy started creating jobs at a pace that caught most economists by surprise. According to the U.S. Department of Labor, the number of U.S. nonfarm jobs grew by 353,000 from February of 2004 to March of 2004. This increase was greater than that of the previous four months combined. March's strong showing was followed by a healthy 324,000 increase in April and a strong 235,000 increase in May. In June, the economy produced 112,000 jobs. The long-awaited job recovery seems to have commenced.

The outlooks for several factors suggest the economy is back in a self-sustained growth mode. Over the forecast period U.S. nonfarm employment is projected to grow 1.2% in 2004, 2.1% in 2005, 1.4% in 2006, and 1.1% in 2007. The last year the number of U.S. jobs increased was in 2000. The U.S. economy is projected to expand over the forecast period. Specifically, U.S. real GDP is anticipated to increase 4.9% this year, 3.8% next year, 2.9% in 2006, and 3.4% in 2007. National real personal income should grow 3.4% this year, 3.8% next year, 3.6% in 2006, and 3.5% in 2007.

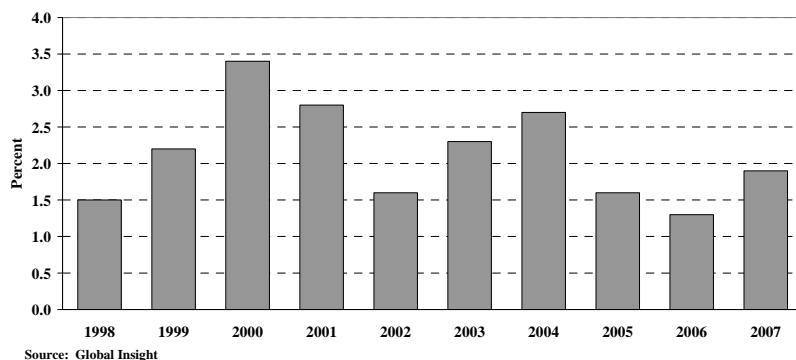
SELECTED NATIONAL ECONOMIC INDICATORS

Consumer Spending: A major concern has been whether rising energy prices would derail consumer spending. This is not idle hand wringing because consumer spending has been a reliable engine of growth during the expansion. The good news is that consumer spending seems to have deflected rising energy prices. Consumer spending has been vigorous, expanding at a 3.9% annual rate in this year's first quarter. This growth reflects the strong showing of several sectors, including computers,

software, apparel, restaurant meals, domestic services, and intercity travel, which all enjoyed double-digit real growth. This strong showing reflects the positive influence of rising household wealth, tax cuts, low interest rates, and job growth. Early indicators show spending has remained robust in the second quarter and should match the first quarter's pace. For example, light vehicle sales soared from a 16.3 million-unit rate in the first quarter to a 17.8 million-unit rate in May. U.S. airlines reported a 10.8% year-over-year rise in revenue passenger miles during the January-April period, with domestic travel rising 8.8% and international travel increasing 16.8%. This not to say energy prices will not have any impact. There is no way a 12.7% increase in 2003 and an expected 9.9% increase this year will not be felt. However, it will not be devastating to consumer markets. Higher energy prices cost consumers \$42 billion last year and will drain an additional \$38 billion from their pocket books this year. Most of this year's increase reflects rising gasoline prices. Despite this increase, real consumer spending growth is expected to accelerate from 3.1% in 2003 to 4.1% in 2004. Part of the reason for this is energy is a relatively small part of consumer spending. This year energy spending will account for 5.1% of spending. While this is slightly up from a low of 4.5% in 2002, it is well below its 9.2% share of spending in 1981. The marginal impact of rising energy prices can also be illustrated with gasoline prices. It is estimated rising gasoline prices will cost the average American household an additional \$330 in 2004. This amount is a small compared to the average U.S. household income of \$82,000. While rising energy prices have received most of the attention, there are other factors, such as steady disposable income growth and improved household balance sheets that point to continued consumer spending growth. Real consumer spending is forecast to rise 4.1% in 2004, 3.3% in 2005, 2.8% in 2006, and 3.0% in 2007. Real disposable income should advance 3.6% this year, 3.2% next year, 3.0% in 2006, and 3.4% in 2007. Because disposable income rises faster than spending in the latter years of the forecast, the personal savings rate improves from 1.8% in 2004 to 2.4% in 2007. Other signs of improving personal finances include the falling rate of personal bankruptcies, lower credit card delinquencies, and rising real net worth.



Consumer Price Inflation

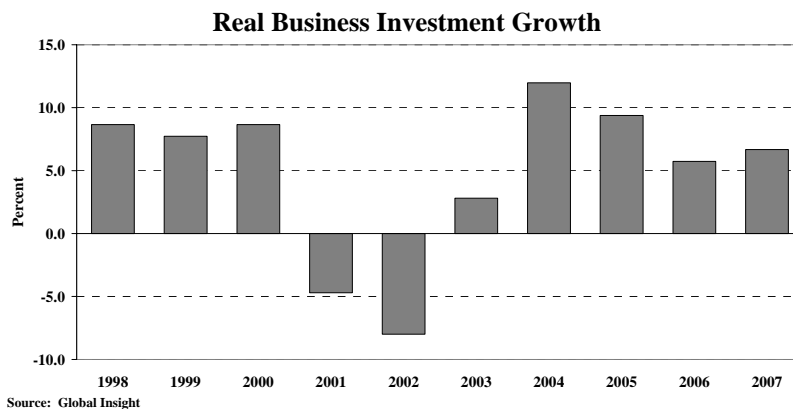


Inflation: The recent jumps in gasoline prices have revived unpleasant memories of runaway inflation. Up until the early 1970s, the price of gasoline had been relatively stable. The first oil embargo put an end to that era. Beginning in early 1973, gasoline prices began to accelerate noticeably. They continued to accelerate so that by the second quarter of 1974 the price of gasoline was nearly 42% higher on a year-over-year basis. The

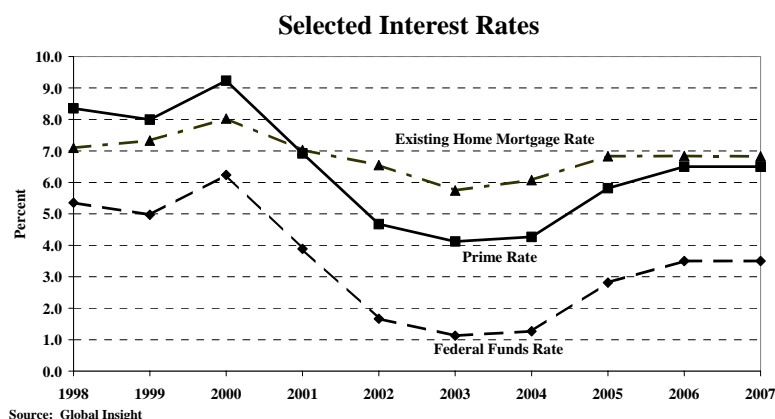
cumulative impact of these increases was the price of gasoline at the end of 1974 was nearly 50% higher than at the end of 1972. Gasoline prices accelerated again beginning in late 1978 due to the Iranian oil embargo. After a protracted run of increases, the price of gasoline in the first quarter of 1980 was 64% higher than its previous year's level. Gasoline prices surged again beginning in late 1990 on fears Iraq's invasion of Kuwait would disrupt oil supplies. What these three episodes have in common is the surges in gasoline prices were accompanied by increase in overall inflation. In each case, the increase in overall inflation led the Federal Reserve to begin tightening and this caused the U.S. economy to slip into a recession. Perhaps the most famous example of this was the actions taken by the "Volcker Fed" and their aftermath. In the late 1970s, an ailing U.S. economy was pummeled by a series of oil increases that caused overall inflation to soar at 16.7% annual rate in early 1980. The federal funds rate climbed as high as 15% during this time, as the nation's central bank wrestled the combination of runaway inflation and slow economic growth known as stagflation. Unfortunately, things would get worse before they got better. The federal funds rate increased to a high of nearly 18% in early 1981 as the battle to extinguish inflation continued. Given the past association between rising gasoline prices and economic hardships, one can understand why the current round of increases revived painful memories. The good news is the links in the chain connecting gasoline price to a recession may be broken. There are a couple of reasons for this conclusion. First, energy is not as big a part of the economy as it used to be. Specifically, the U.S. economy is 50% more energy efficient than it was in 1981 and twice as efficient as it was in 1974. Second, believe it or not, the recent rise in energy prices does not come close to previous price run-ups. For example, although the price of oil has increased 45% recently, this is small compared to the nearly 100% increase in 1981. It should be added that energy prices seem to be near their peak, so they should be headed down in the near future. The inflation outlook rests not with energy prices, but with how quickly the gap between U.S. actual and potential output closes. This forecast assumes this gap will be bridged slowly, so inflation will remain moderate. Specifically, consumer inflation, as measured by the CPI, is anticipated to be 2.7% in 2004, 1.6% in 2005, 1.3% in 2006, and 1.9% in 2007.

Business Investment: Strong fundamentals suggest real business investment will expand over the forecast period. This is a welcome change from recent years where business investment sank under the weight of its collapsing equipment component. Real spending on equipment and software declined for seven straight quarters beginning with the fourth quarter of 2000. The crash of high technology is frequently cited as playing a major role in the plunge of investment spending. However, a look at GDP's share of investment does not support this accusation.

From a peak of 12.6% of GDP in the fourth quarter of 2000, the share of total investment shrank to 10.0% early last year. The high-tech portion of that 2.6 percentage point decline was less than one-third, leaving low-tech equipment and structures accounting for more than two-thirds of the drop. While it is true technology was shrinking faster than the rest of investment from the end of 2000 through the third quarter of 2001, after 2002, technology goods mirrored the economy and then raced ahead of it. The "investment problem" is that old-line, low-tech investment continued to lose ground until recently. Real investment on equipment and software shifted into high gear in the second half of last year. It has continued expanding since then, and it should continue expanding through most of the forecast period. Positive factors for this sector include a huge increase in non-defense capital goods in March. Business confidence has improved from doom and gloom to sunny days. Businesses have begun to hire again, and they will need to provide new workers with the equipment to perform their



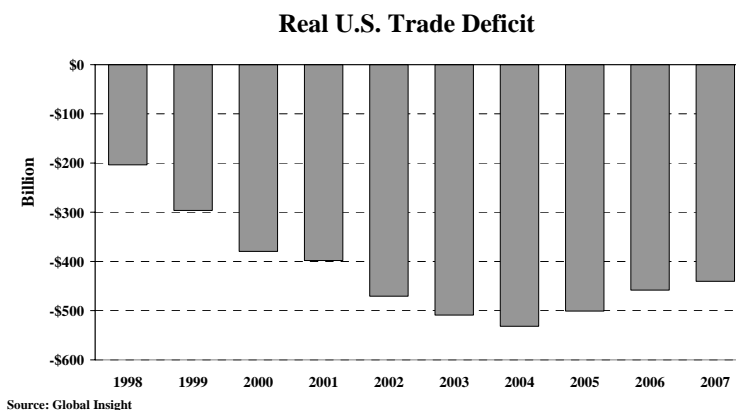
jobs. Businesses can no longer restrain capital outlays and still get the kind of returns they had been generating recently. It is worth pointing out a major anomaly will distort the timing of spending this year and next. Accelerated depreciation is set to expire this year. As such, business investment growth rates will be inflated during the second half of this year as businesses attempt to beat this important deadline. This should lead to a decline in spending during the first quarter of next year. Total real business spending is expected to increase 12.0% this year, 9.4% next year, 5.7% in 2006, and 6.7% in 2007. Real investment on equipment and software is expected to grow slightly faster than business investment. Specifically, real spending on equipment and software is anticipated to rise 14.0% in 2004, 9.0% in 2005, 6.5% in 2006, and 7.3% in 2007.



Financial: To no one's surprise the Federal Reserve increased its bellwether federal funds rate 25 basis points on June 30, 2004. This move was widely anticipated because members of the Federal Open Market Committee have been hinting for some time their next move would be to raise rates. This increase finally became feasible thanks to the improved labor market and diminished risks of deflation. What is unusual about the move is that it came in a presidential

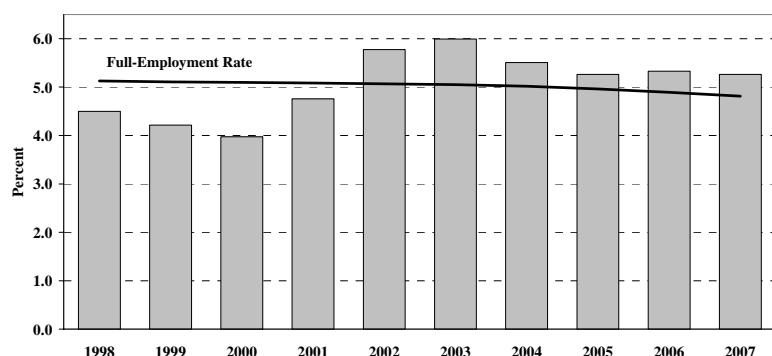
election year. Traditionally, the Federal Reserve rarely makes policy moves in an election year. However, circumstances during this round of increases are hardly normal. First, the Federal Reserve has been in a stimulus mode for four years, which is unusually long. Second, the federal funds rate was 1.0%, its lowest level since the 1950s, for over a year prior to the increase. Third, the increase was just 25 basis points, which is hardly earth shattering. Fourth, the Federal Reserve has been broadcasting the increase for several months, so other interest rates already reflected the higher federal funds rate even before the Federal Reserve made its move. Since the question of when the Federal Reserve will begin raising rates has been answered, the question of how it will raise rates has moved to the forefront. Fortunately, we are not completely in the dark about the central bank's methods. The Federal Reserve has mentioned it will take measured steps to fight inflation. This has been interpreted to mean any increases will be gradual. Indeed, this forecast assumes the Federal Reserve will raise its federal funds rate slowly to 2.0% by year's end. It is expected to be 3.5% by the end of 2005. Admittedly, this may be a bit on the low side. Financial markets are betting the federal funds rate will be in the 3.75%-4.00% range at the end of next year. The forecast for the federal funds rate and several other key interest rates are included in the accompanying chart.

International: The outlook for the international economy is bright. Not only does 2004 promise to enjoy the strongest global economic growth since 1988, but there is also sufficient spare capacity worldwide for the expansion to average just over a 3.0% annual pace after this year. Recent news from the Eurozone has been pleasantly surprising. First quarter GDP growth came in at a 2.3% annualized rate—its best showing since the first quarter of 2001. Growth was primarily generated by net exports, rather than



domestic demand, but consumption did grow faster than expected, calming fears that consumer spending had hit a wall. Asia should have a banner year in 2004. Japan should post strong growth this year. After being in a seemingly terminal recession, Japan's real GDP advanced at a 6.1% annual pace in the first quarter this year, and it should experience more than 4.0% growth for the entire year. As in the past, Asia's growth engine will be China. Latin America is also improving. Mexico's GDP grew at a 3.6% annual pace in this year's first quarter. Latin America's economy excluding Mexico should grow by more than 4.0% this year—its strongest showing since 1997. Although the international picture is fairly rosy, it is not without risks. For example, the United States and China account for a disproportionately large share of the global expansion. The concern is these two growth engines may slow down with no other drivers to take over. Another potential risk to the expansion is rising oil prices. Higher oil prices add to inflation and drain the purchasing power of oil-consuming nations. An oil price sustained at around \$40 per barrel would dampen the expansion, but it would not derail it. Unfortunately, the U.S. trade deficit is not expected to improve quite as quickly as the global economy. The trade deficit hit a record \$48.3 billion this April. The prospect of quicker U.S. interest rate increases should give the currency some support, but the widening trade gap implies the dollar must fall further to encourage exports and discourage imports. The current forecast assumes the dollar will continue to fall through the forecast period. The real net export deficit is expected to peak this year at \$532 billion, and then recede to \$441 billion in 2007.

U.S. Civilian Unemployment Rate



Source: Global Insight

Employment: It appears that after a few misfires the long-awaited U.S. job recovery has commenced. With a hat trick of solid monthly job growth beginning in March 2004, the last part of the recovery appears in place. According to the U.S. Department of Labor, the number of nonfarm jobs grew by 353,000 from February of 2004 to March of 2004. This increase was greater than that of the previous four months combined. March's strong showing was followed by a healthy

324,000 increase in April and a strong 235,000 increase in May. In June, the economy produced 112,000 jobs. While this was lower than in previous months, it was a move in the right direction. All told, there are 1.3 million more nonfarm jobs in June 2004 than there were at the end of last year. The growth since February marks another important milestone: the return of manufacturing jobs. Like other sectors, the manufacturing sector has shed jobs recently. However, the manufacturing sector's losses have been particularly devastating. For example, this sector has lost about one out of five jobs from March 1998 to January 2004. In comparison, the U.S. economy shed about one out of 50 jobs over about a two-year period. Despite the recent job gains, the unemployment rate has remained at 5.6% this entire year. This is not unexpected. When the job situation starts to improve, previously discouraged workers reenter the labor force. Thus, even though the number of people employed is rising, so is the labor force. The unemployment rate, which is simply the number of people in the labor force without jobs divided by the labor force, will not decline until the number of people finding jobs grows faster than the labor force expands. The unemployment rate is expected to begin falling gradually beginning the second half of this year. Specifically, the U.S. civilian unemployment rate should be 5.4% by year's end and 5.3% by the end of 2007. Despite this improvement, the economy is not expected to achieve its full-employment rate over the forecast period. The last time the labor force was at full employment was in late 2001. The number of U.S. nonfarm jobs should rise 1.2% in 2004, 2.1% in 2005, 1.4% in 2006, and 1.1% in 2007.

Housing: Housing turned in a solid but unspectacular month in April. While it failed to be another record month, it stayed within 5% of the peak levels of the housing boom on several fronts. Existing home sales fell short of last September's peak by 40,000 or just 0.5%. Total housing units authorized missed their October 2004 peak by a mere 0.8%. April housing starts were 1.969 million units, which was nearly 5.0% below last December's record showing. A major concern is how

rising interest rates will affect the housing sector. After hitting a low in March 2004, the 10-year note yield had risen by 100 basis points by April 2004, and mortgage interest rates have matched this increase. The 30-year mortgage interest rate has risen from 5.38% in mid May to 6.21% in early July. This increase did cause a serious disruption to the housing market. The Mortgage Bankers Association index of conventional financing purchase applications suggests activity remained strong through early June. The National Association of Homebuilders' Market Index held steady at a robust 69 in May, with buyer traffic at a 13-month high. While some of this health may be the result of fence sitters jumping into the housing market before rates rise further, the market is also being buoyed by stronger job and income growth. Due in large part to these latter factors, the housing expansion is anticipated to end with a whimper instead of a bust. This year is expected to be stronger than 2003, but the housing sector should taper off thereafter. Specifically, after hitting 1.90 million units in 2004, the total number of housing units should slide to 1.69 million units next year, 1.63 million units in 2006, and 1.65 million units in 2007.

